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| In the Matter of                          | ) |                      |
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| Qwest Communications International Inc.,  | ) |                      |
| Consolidated Application for Authority to | ) |                      |
| Provide In-Region, InterLATA Services in  | ) | WC Docket No. 02-148 |
| Colorado, Idaho, Iowa, Nebraska and North | ) |                      |
| Dakota                                    | ) |                      |
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| Montana, Utah, Washington and Wyoming     | ) |                      |
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David W. Carpenter  
SIDLEY AUSTIN BROWN & WOOD  
Bank One Plaza  
10 South Dearborn Street  
Chicago, Illinois 60603  
(312) 853-7000

David L. Lawson  
Mark Schneider  
C. Frederick Beckner III  
Michael J. Hunseder  
SIDLEY AUSTIN BROWN & WOOD, L.L.P.  
1501 K St., N.W.  
Washington, D.C. 20005  
(202) 736-8000

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## FCC ORDERS CITED

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| <i>Accounting Safeguards Order</i> | Report and Order, <i>Accounting Safeguards Under the Telecommunications Act of 1996</i> , 13 FCC Rcd. 21879 (1996).  |
| <i>Ameritech Michigan Order</i>    | Memorandum Opinion and Order, <i>Application of Ameritech Michigan Pursuant to Section 271 to Provide In-Region, InterLATA Services in Michigan</i> , 12 FCC Rcd. 19985 (1997).  |
| <i>BA/NYNEX Merger Order</i>       | Memorandum Opinion and Order, <i>In re NYNEX Corp., and Bell Atlantic Corp., for Consent to Transfer Control of NYNEX Corp., and its Subsidiaries</i> , 12 FCC Rcd. 7236 (1997).   |
| <i>Michigan 271 Order</i>          | Memorandum Opinion and Order, <i>Application of Ameritech Michigan Pursuant to Section 271 to Provide In-Region, InterLATA Services in Michigan</i> , 12 FCC Rcd. 20543 (1997).  |
| <i>SBC 271 NAL</i>                 | Notice of Apparent Liability for Forfeiture and Order, <i>SBC Communications Inc., Apparent Liability for Forfeiture</i> , 16 FCC Rcd. 19901 (2001).   |
| <i>Texas 271 Order</i>             | Memorandum Opinion and Order, <i>Application by SBC Communications Inc., et al Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas</i> , 15 FCC Rcd. 18354 (2000). |

**Before the  
Federal Communications Commission  
Washington, DC 20554**

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**SUPPLEMENTAL COMMENTS OF AT&T CORP.  
REGARDING QWEST’S COMPLIANCE WITH 47 U.S.C. § 272**

Pursuant to the Commission’s August 29, 2002 Public Notice in this proceeding, AT&T Corp. (“AT&T”) respectfully submits these supplemental comments.

**INTRODUCTION AND SUMMARY**

On August 16, Qwest’s newly-hired chief financial officer, Oren G. Shaffer, informed the Securities and Exchange Commission (“SEC”) that he would be “unable to express a view concerning the accuracy and completeness” of Qwest’s financial statements in light of ongoing internal and outside investigations of Qwest’s widely-reported accounting improprieties.<sup>1</sup> Qwest’s new auditors are likewise unwilling at this time to offer any opinion regarding the extent

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<sup>1</sup> Qwest Communications International Inc. Form 8-K (Aug. 16, 2002) at 10 (“August 16 Qwest 8-K”) (attached hereto as Exhibit 1).

of Qwest's accounting problems or when (or how) they will be resolved.<sup>2</sup> As Mr. Shaffer explains, although Qwest and its auditor have already "preliminarily concluded" that Qwest's books are off by more than a *billion* dollars, the "internal analyses are not complete" and "new issues may be raised."<sup>3</sup> Although Mr. Shaffer's statement provides little detail, the issues already under review are shockingly reminiscent of other recent accounting scandals and apparently "include, but are not limited to," the inflation of revenues and profits through sham optical capacity "asset sales" and "swaps," the improper recognition of future revenue in current periods, the capitalization of expenses, and unspecified "other" accounting practices.<sup>4</sup>

Qwest has informed the Securities and Exchange Commission ("SEC") that its accounting problems are so widespread and complex that Qwest simply "cannot state" when its investigations or remedial actions will be completed.<sup>5</sup> And, as Mr. Shaffer's statement makes clear, even after Qwest's investigations are complete and the entire web of accounting violations is untangled and corrected with restatements, more will remain to be done to "enhance certain internal controls" before there can be any assurance of future compliance with generally accepted accounting principles ("GAAP"). Qwest's accounting problems are extraordinarily serious, and they have triggered formal and ongoing investigations by, among others, the SEC, Congress and the Criminal Division of the Department of Justice.<sup>6</sup>

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<sup>2</sup> *Id.* at 10-11

<sup>3</sup> *Id.* at 11.

<sup>4</sup> *Id.* at 11-12.

<sup>5</sup> Qwest Communications International Inc. Form 8-K (Aug. 8, 2002), Exh. No. 99.1 at 1 (August 8 Qwest 8-K") (attached hereto as Exhibit 2)

<sup>6</sup> See, e.g., Michael Hedges and Tom Fowler, *Qwest Trade with Enron Questioned*, Houston Chronicle (July 11, 2002) ("A telecommunications deal last fall between Enron Corp. and Qwest Communications International is being scrutinized by a federal task force investigating Enron . . . . The deal involved a trade between Enron and Qwest of fiber optic network capacity and other  
(continued . . .)

It is against this backdrop that Qwest now seeks in the very final days of this proceeding to push the Commission into making a rash and uninformed finding that Qwest's books and records will comply with GAAP by September 11 (the 90<sup>th</sup> day of this application period). Given that Qwest itself refuses to hazard a guess at when its pervasive accounting problems will be rectified, there is no possible basis for any such Commission finding. To the contrary, as detailed below, Qwest's revelation last week that its section 272 affiliate, QCC, is the very Qwest entity that has engaged in the accounting shenanigans that violate GAAP and that are under investigation poses an absolute legal bar to Commission approval of Qwest's pending section 271 applications. Granting the applications in the face of this clear legal defect could only lead to reversal (and would provide particularly strong grounds for a stay pending appeal). It would also place the Commission in an exceedingly bad light. Indeed, it is unthinkable that the Commission would refuse to enforce the Communications Act's core accounting protections

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(... continued)

assets that the company valued at more than \$500 million . . . . Analysts have described the Enron-Qwest deal as a highly questionable transaction aimed at giving a false impression of improving revenues. . . . The idea in deals like this is to show earnings or hide losses at the end of the quarter. That is why the appearance is of a bogus transaction.”); Kathleen Day, *SEC Targets “Swap” Deals by Telecom Firms*, The Washington Post, at E1 (August 20, 2002) (“The Securities and Exchange Commission has ruled invalid an accounting rationale used by some telecommunications companies to justify deals in which they appeared to trade access to one another’s wires . . . . In early 2001, for instance, Global Crossing paid \$100 million for the long-term right to transmit information via a fiber-optic network build by Qwest. About the same time, Qwest paid \$100 million for the right to use Global Crossing’s network over a similar 25-year period.”); Robert Schmidt, *SEC Bans Accounting Methods at Telecoms*, National Post, at FP16 (Aug. 21, 2002) (“Global Crossing and Qwest didn’t just swap with themselves, they were involved with many others. . . . The SEC has indicated that it expects public companies to make the change by retroactive restatement.”); Mark Couch, *SEC Warns About “Swap” Transactions*, Denver Post (Aug 21, 2002) (“The swap issue is more serious because there is a potential conspiracy to commit fraud, said telecommunications analyst Scott Cleland.”); Dennis Berman and Deborah Solomon, *Questions Surround Telecom Pioneer*, The Asian Wall St. Journal (Feb. 14, 2002) (“Among the most aggressive was Qwest, which booked revenue from the swaps up front.”).

at the same time that other government bodies are working so diligently to combat accounting misconduct and its many destructive and anticompetitive consequences through strict enforcement of accounting requirements.

The principal legal defect exposed by Qwest's last-minute *ex parte* submissions is quite straightforward. Qwest has now confirmed that, contrary to the false assertions in the declarations it filed with its applications, its section 272 affiliate, Qwest Communications Corporation ("QCC"), the Qwest entity at the center of ongoing civil, congressional and criminal accounting fraud investigations, does not, as section 272(b)(2) requires, "maintain books, records, and accounts in the manner prescribed by the Commission."<sup>7</sup> That is fatal to Qwest's applications. Section 272(a) prohibits a BOC from originating "any" in-region interLATA telecommunications service, "unless it provides that service" through a 272 affiliate that "meets the requirements of subsection (b)" of section 272.<sup>8</sup> And the Commission "shall not approve" a BOC's request for interLATA authority unless "the requested authorization will be carried out in accordance with the requirements of section 272."<sup>9</sup> Qwest could not possibly carry out the requested authorization in accordance with the requirements of section 272 for the simple reason that it lacks any qualified 272 affiliate (*i.e.*, one that maintains books, records and accounts in accordance with GAAP) that could lawfully provide interLATA service.

This is no mere technicality or trifle. As the Commission has repeatedly stressed, "compliance with section 272 is 'of crucial importance' because the structural, transactional, and nondiscrimination safeguards of section 272 seek to ensure that BOCs compete on a level

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<sup>7</sup> 47 U.S.C. § 272(b)(2).

<sup>8</sup> *Id.* § 272(a).

<sup>9</sup> *Id.* § 271(d)(3).

playing field.”<sup>10</sup> Compliance with section 272(b)(2), in particular, is necessary to create “a uniform audit trail,”<sup>11</sup> that “discourages, and facilitates detection of, improper cost allocations.”<sup>12</sup> For that reason, the Commission’s rules implementing section 272(b)(2) provide that “the separate affiliates prescribed under section 272(a)(2) *must* maintain their books, records, and accounts in accordance with GAAP.”<sup>13</sup> Absent strict and uniform adherence to GAAP, Qwest could easily fool auditors and regulators seeking to detect improper cost allocations, just as Qwest has, through GAAP violations, apparently been fooling investors, lenders and regulators for years.

Nor is there any doubt that Qwest fails to meet the section 272(b)(2) requirement. On August 20, Qwest expressly confirmed with respect to its 272 affiliate both that it “is currently unable to certify that QCC’s . . . financial statements are accounted for consistently with GAAP,” and that the investigations and analyses of what “additional controls” are necessary to “ensure QCC’s . . . compliance with GAAP” remain ongoing.<sup>14</sup> And, on August 26, Qwest confirmed that QCC is in fact the Qwest entity that has been engaging in the improper accounting transactions that are the subject of the SEC and criminal investigations.<sup>15</sup> That should be the end of the matter. The Commission cannot rationally find that Qwest will on September 11 be in a position to provide interLATA service through a 272 affiliate that maintains separate GAAP-

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<sup>10</sup> *Texas 271 Order* ¶ 395 (2000).

<sup>11</sup> *Accounting Safeguards Order* ¶ 170.

<sup>12</sup> *Id.* ¶ 13.

<sup>13</sup> *Id.* ¶ 170 (emphasis added).

<sup>14</sup> August 20, 2002 *Ex Parte* Letter from Oren G. Shaffer to Marlene Dortch (“August 20 Shaffer Letter”) at 1-2.

<sup>15</sup> *See* August 26, 2002 Letter from R. Steven Davis to Marlene Dortch (“August 26 Davis Letter”) at n.1.



compliant books and records when Qwest's sworn statements to the SEC confirm that Qwest cannot even promise that.

In a remarkable exercise of semantic gymnastics, Qwest nonetheless maintains that it is in full compliance with section 272(b)(2). Qwest's principal argument is that the "focus" of section 272 is transactions between the BOC and the 272 affiliate and that "[n]one" of the accounting irregularities at issue concerns these transactions.<sup>16</sup> Even if that were true – and, as described below, there is no basis for any such conclusion – it would be legally irrelevant. Section 272 requires *both* that interaffiliate transactions be accounted for in accordance with GAAP<sup>17</sup> *and, independently*, that the 272 affiliate maintain GAAP-compliant books, records and accounts.<sup>18</sup> As the Commission has recognized in this very context, it is the most fundamental "principle of statutory construction that a statute should be construed so as to give effect to each of its provisions."<sup>19</sup> Under Qwest's reading, the vital protections of section 272(b)(2) would simply be read out of the statute.

Giving independent content to section 272(b)(2) is not only required as a matter of statutory construction but is necessary to effectuate the core purposes of the statute. First, the accounting safeguards of section 272(b)(2) provide an invaluable tool to detect anticompetitive price squeezes by requiring the affiliate to maintain GAAP-compliant books that accurately reflect the affiliate's expenses, revenues and profits. Second, the requirement that the 272 affiliate maintain all of its books and records (and not just those that reflect transactions with its

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<sup>16</sup> August 26 Davis Letter at 4; *see also* August 26, 2002 Letter from Oren G. Shaffer to Marlene Dortch at 1 ("August 26 Shaffer Letter").

<sup>17</sup> 47 U.S.C. § 272(c)(2).

<sup>18</sup> *Id.* § 272(b)(2).

<sup>19</sup> *Accounting Safeguards Order* ¶ 156.

affiliates) in accordance with GAAP provides a critically important “uniform audit trail” that allows the Commission, state regulators, and others to compare the 272 affiliate’s transactions with the BOC to similar transactions between the 272 affiliate and third parties to determine whether transactions between the 272 affiliate and BOC are truly “arm’s length” (or instead reflect special terms designed to subsidize the affiliate).<sup>20</sup> Finally, requiring separate affiliates to maintain all of their books, records and accounts in accordance with GAAP “impose[s] some degree of uniformity upon these affiliates” thereby allowing the Commission and state agencies to “benchmark” RBOC long distance affiliates against each other.<sup>21</sup>

Qwest also argues that it has fixed all of QCC’s accounting problems “going-forward” and assures the Commission that all future entries in its books and records will be GAAP-compliant.<sup>22</sup> This cannot be squared with Qwest’s contrary statements to the SEC. There, Qwest has expressly disclaimed any conclusion that its prior accounting irregularities have been fully identified or that new GAAP-compliant accounting treatments have been substituted for existing non-compliant accounting policies. As Qwest has explained to the SEC, the billions of dollars of restatements it currently anticipates largely reflect Qwest’s *failures to apply* its own accounting policies, and not Qwest’s ongoing analyses of whether the Qwest revenue recognition *policies themselves* violate GAAP. Both Mr. Shaffer and Qwest’s new chief executive officer, Richard Notebaert, have stated under oath that upon completion of those analyses, which are just underway and are expected to take months, Qwest may determine that QCC’s existing policies

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<sup>20</sup> *Id.* ¶ 170.

<sup>21</sup> *Id.*

<sup>22</sup> August 26 Shaffer Letter at 1.

are inappropriate.<sup>23</sup> There is accordingly no possible basis for a Commission finding that QCC's accounting entries will be GAAP compliant on a going-forward basis on September 11. Moreover, QCC's "books, records, and accounts" plainly include past accounting entries as well as future ones, and thus QCC could not be said to be in compliance with section 272(b)(2) even if Qwest could responsibly represent that its existing accounting policies are GAAP compliant.

Nor can Qwest avoid the consequences of its sworn statements to the SEC by suggesting that "financial statements" are not "books, records, and accounts." The courts have rejected that argument.<sup>24</sup> In any event, the reason Qwest cannot certify its financial statements is *because* its "books, records, and accounts" are not in compliance with GAAP. Financial statements are not documents created out of whole cloth but are summaries of the entries made in the "books, records, and accounts." Qwest has acknowledged that many of the entries in its books are erroneous and that its ongoing investigation may uncover more. Moreover, these errors have present effect. For example, QCC's books should currently include entries showing ongoing revenues being produced from the leasing of indefeasible rights of use ("IRUs") for fiber optic capacity, but they do not because QCC improperly accounted for all of the revenue from the IRUs up front. Thus, until Qwest fully implements new accounting policies (which are still being formulated as part of its internal review), corrects its improper entries (including those being made today under existing policies that will be superceded), and puts controls in place to ensure that the new policies are properly implemented, Qwest cannot be said to be "maintain[ing] books, records, and accounts" in accordance with GAAP.

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<sup>23</sup> See August 16 Qwest 8-K at 5-8, 9-12.

<sup>24</sup> *US v. Crop Growers Corp.*, 954 F. Supp. 335, 355-57 (D.D.C. 1997).

In any event, Qwest has not demonstrated compliance with even the GAAP requirement that it concedes it must satisfy. Qwest's recent proclamations that all of its BOC-272 affiliate transactions "have been, and are" accounted for in accordance with GAAP simply cannot be credited, given Qwest's past violations of the section 272 affiliate transactions rules, Qwest's nearly simultaneous sworn statements that its internal investigations are ongoing, and evidence that the interaffiliate transactions between the BOC (Qwest Corporation "QC") and QCC include optical capacity deals – the very same type of transactions that Qwest has already recognized that it handled improperly and that are the subject of both civil and criminal investigations.

This is neither the place nor the time to cut corners. Anything but full and complete enforcement of the Act's clear accounting pre-conditions to section 271 authority would quite properly be viewed as reluctance by the Commission to do its part to combat accounting abuses. In the present environment, that would bring dishonor upon the Commission and send precisely the wrong message to the companies regulated by the Commission, particularly given that recent equipment, merger and section 272 audits have revealed a great need for much closer attention to accounting compliance and enforcement issues (and that the Chairman himself has recently declared a moratorium on the relaxation of current accounting safeguards).

To be sure, certain regulators and legislators will be disappointed by the necessary delay in Qwest's interLATA entry (although certainly not as many as would be disappointed were the Commission, at Qwest's urging, effectively to abandon the accounting oversight field). But that is Qwest's own doing, and it is entirely within Qwest's control to take the steps necessary to come into compliance. Until Qwest does so, the only lawful Commission response is to reject the pending applications.

## ARGUMENT

### I. QWEST'S SEPARATE LONG DISTANCE AFFILIATE DOES NOT SATISFY SECTION 272(b)(2).

The Commission “shall not approve” a BOC’s request for interLATA authority unless “the requested authorization will be carried out in accordance with the requirements of section 272.”<sup>25</sup> Section 272 in turn prohibits a BOC from originating “any” in-region interLATA telecommunications service, “unless it provides that service” through an affiliate that “meets the requirements of subsection (b)” of section 272.<sup>26</sup> Among those requirements is that the 272 affiliate “maintain books, records, and accounts in the manner prescribed by the Commission.”<sup>27</sup> Although Qwest’s application and accompanying declarations claimed compliance with this requirement, recent Qwest statements unequivocally demonstrate that Qwest’s long distance affiliate does *not* maintain books, records, and accounts “in the manner prescribed by the Commission” – *i.e.*, GAAP-compliant books, records, and accounts – and, indeed, is unable to state when it will be in a position to do so.<sup>28</sup>

Specifically, Qwest filed with its application the declaration of Judith Brunsting. Ms. Brunsting testified that Qwest’s long distance affiliate, QCC, “follows Generally Accepted Accounting Principles” and that the “Affiliate’s books, records, and accounts are maintained in accordance with GAAP.”<sup>29</sup> Those statements are demonstrably false.

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<sup>25</sup> 47 U.S.C. § 271(d)(3)(B).

<sup>26</sup> *Id.* § 272(a).

<sup>27</sup> *Id.* § 272(b)(2).

<sup>28</sup> The Commission mandated GAAP accounting for 272 affiliates in Paragraph 170 of its *Accounting Safeguards Order*.

<sup>29</sup> Brunsting Dec. ¶ 29.

On July 28, Qwest issued a press release to announce “the current status of the ongoing analysis of its accounting policies and practices.”<sup>30</sup> Qwest stated that “[b]ased on the analysis to date, the company has determined that it has in some cases applied its accounting policies incorrectly.”<sup>31</sup> On August 16, 2002, Qwest informed the SEC that it could not certify that its accounting financial statements are truthful.<sup>32</sup> Then, on August 20, 2002, Qwest submitted to the Commission an *ex parte* letter from its new CFO, Mr. Shaffer, conceding that the accounting irregularities discovered to date involved QCC, the 272 affiliate. “Internal investigations have now identified, with respect to the . . . QCC financial statements . . . accounting transactions for QCC that did not comply with the requirements of GAAP. Additional analysis is in progress regarding these matters.”<sup>33</sup> Thus, “QCII [QCC’s parent] is currently unable to certify that QCC’s . . . financial statements are accounted for consistently with GAAP.”<sup>34</sup>

Qwest belatedly recognized that Mr. Shaffer’s admissions compelled rejection of its pending applications. Six days later, Qwest filed another *ex parte* letter from Mr. Shaffer “clarifying” his previous statement, as well as an *ex parte* letter from one of its lawyers, Mr. R. Steven Davis, which set forth Qwest’s legal arguments as to why the Commission could find that QCC satisfied section 272(b)(2), notwithstanding QCC’s admitted failure to maintain GAAP-compliant books, records and accounts.<sup>35</sup> Qwest also revised the Brunsting declaration with new

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<sup>30</sup> Qwest Communications International Inc. 8-K (July 29, 2002) (filing July 28, 2002 press release with the SEC) (“July 29 Qwest 8-K”) (attached hereto as Exhibit 3).

<sup>31</sup> *Id.*

<sup>32</sup> *See generally* August 16 Qwest 8-K .

<sup>33</sup> August 20 Shaffer Letter at 2.

<sup>34</sup> *Id.* at 1.

<sup>35</sup> *See generally* August 26 Shaffer Letter; August 26 Davis Letter.

language that was intended to eliminate the tension between Ms. Brunsting's untrue statement that QCC was keeping its books in accordance with GAAP and Mr. Shaffer's true statement that it was not.<sup>36</sup>

But these last-minute attempts to salvage the pending applications only further doom them. Both Mr. Davis and Mr. Shaffer make the extraordinary assertion that "subject to . . . restatement" QCC maintains GAAP-compliant books, records and accounts. But, of course, even the most fraudulent books, records and accounts (or, indeed, books, records and accounts populated entirely with "zeros") would satisfy that meaningless standard, because *any* non-compliant books, records and accounts could, in theory, be restated to be GAAP-compliant.<sup>37</sup> The problem for Qwest here is that its books, records and accounts are so corrupted with improper entries that it will be months, at best, before Qwest even knows the full extent of the problems and can begin to correct past entries and to implement new controls adequate to ensure that such GAAP violations will not recur. As Mr. Shaffer confirmed, the internal investigation to determine the full extent of the accounting irregularities and "any new internal controls that are needed" to prevent GAAP violations from continuing into the future "is ongoing and expected to take several months before it is completed."<sup>38</sup>

Despite this express recognition that QCC has, in many ways and to the tune of billions of dollars, improperly accounted for many of the transactions that appear in the books, records

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<sup>36</sup> See August 27, 2002 Letter from Peter A. Rohrbach to Marlene Dortch (attaching revised paragraph 29 to Brunsting Declaration) ("August 27 Rohrbach Letter").

<sup>37</sup> See August 26 Davis Letter at 3.

<sup>38</sup> August 26 Shaffer Letter at 2. In his August 26 letter, Mr. Davis acknowledges pervasive accounting irregularities involving QCC and that Qwest will need to restate its financials with respect to, among other things, "optical capacity sales by QCC to third parties, certain equipment sales by QCC to third parties," and "accounting for telecommunications services in transactions between QCC and third party carriers." August 26 Davis Letter at 2 n.1.

and accounts that Qwest maintains for QCC, Qwest asserts that it has “satisfie[d] [its] obligations under section 272(b)(2).”<sup>39</sup> First, Qwest says that “[n]one” of the reasons why QCC’s books fail to comply with GAAP “relate to transactions between QCC [the section 272 affiliate] and QC [the BOC], and therefore none implicate section 272.” *Id.* at 2 n.1. But even if the premise of Qwest’s argument was true (and, as described below in Part II, Qwest has not demonstrated that it is), Qwest’s conclusion would not follow. Section 272 contains *two* separate accounting obligations. Section 272 requires *both* that interaffiliate transactions be accounted for in accordance with GAAP (47 U.S.C. § 272(c)(2)) *and, independently*, that the 272 affiliate maintain its books and accounts consistently with GAAP (*id.* § 272(b)(2)).

Qwest cannot comply with the latter requirement merely by claiming that it has complied with the former. To the contrary, the Commission must give independent meaning to both statutory provisions.<sup>40</sup> Indeed, the Commission has made this point in this very context:

We adopt our tentative conclusion that the “operate independently” requirement of section 272(b)(1) imposes requirements beyond those listed in sections 272(b)(2)-(5). This conclusion is based on the principle of statutory construction that a statute should be construed so as to give effect to each of its provisions.<sup>41</sup>

That means Qwest must demonstrate that its BOC-affiliate transactions are GAAP-compliant *and* that its affiliate is maintaining its books, records and accounts – *all* of its books, records and accounts – in accordance with GAAP. Thus, even if Qwest could establish that some subset of QCC’s books, records and accounts – *e.g.*, those that reflect transactions with the BOC, QC – are GAAP-compliant, that showing could not satisfy its obligation to demonstrate, as section

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<sup>39</sup> August 26 Davis Letter at 3.

<sup>40</sup> *See Reiter v. Sonotone Corp.*, 442 U.S. 330, 339 (1979) (statutes should be interpreted to give effect to every provision); *Moskal v. United States*, 498 U.S. 103, 109-111 (1990) (same).

<sup>41</sup> *Accounting Safeguards Order* ¶ 156.



272(b)(2) requires, that QCC maintains all of its books, records and accounts in compliance with GAAP.

Qwest is, of course, correct that strict enforcement of section 272(c)(2) is necessary to prevent the BOC from providing its long distance affiliate with preferential terms not available to other carriers. But strict enforcement of the additional safeguard that Congress imposed in section 272(b)(2) is equally important to ensure a level long distance playing field. The Commission has recognized that a BOC will retain substantial bottleneck local market power even after its local markets are sufficiently “open” to competition to satisfy the section 271 checklist. That enduring local market power (and the substantial portion of any long distance carrier’s costs represented by local access charges) provides myriad opportunities for the BOC and its 272 affiliate to “price squeeze” long distance competitors by, for example, having the affiliate charge rates that are below the costs faced by other long distance carriers. The RBOC affiliate does not need to charge prices below its true economic costs to squeeze out long distance competitors because these competitors must pay above-cost access charges to originate and complete their calls. Thus, the combined RBOC can undercut its competitors but still earn a profit. The section 272(b)(2) accounting safeguards provide a valuable tool to detect price squeezes by requiring the affiliate to keep its own books and to maintain those books in a way that accurately reflects expenses, revenues and profits. In contrast, absent proper (and uniform) GAAP accounting, an RBOC could cover-up a price squeeze strategy by using improper accounting techniques with respect to third party transactions (as Qwest apparently did) to inflate the revenues earned by the long distance affiliate.

Giving independent meaning to section 272(b)(2) is necessary for other important reasons as well. Assessing whether a transaction between a BOC and its long distance affiliate is

discriminatory is often quite difficult. The requirements that the 272 affiliate maintain all of its books, records and accounts (and not merely those that reflect affiliate transactions) in accordance with GAAP provides “a uniform audit trail,” thus allowing the Commission, state regulators, and others to *compare* the 272 affiliate’s transactions with the BOC to similar transactions with third parties.<sup>42</sup> In other words, the Commission and state agencies can use non-affiliate transactions as a benchmark for determining whether transactions between the BOC and the long distance affiliate are truly at “arm’s length” and are non-discriminatory or are, instead, sham transactions designed to cross-subsidize the affiliate (by, for example, having the BOC pay above-market rates for “services” provided by the affiliate). But that is not possible unless *both* sets of transactions are accounted for under uniform GAAP principles.

Even a cursory review of Qwest’s website posting of affiliated transactions underscores the particular importance of uniform GAAP accounting by QCC. Unlike other BOC 272 affiliates, QCC is a pre-existing facilities-based long distance carrier (namely, the pre-merger Qwest) that has extensive out-of-region operations and revenues. A substantial portion of QCC’s revenues are attributable to sales of optical capacity on its fiber network (one of the categories of transactions subject to the ongoing civil and criminal investigations). As discussed in more detail in Part II below, QCC enters into such transactions not only with third parties, but also with its BOC affiliate, QC. Such sales by a 272 affiliate to its parent present obvious opportunities for the BOC to funnel money to the 272 affiliate by agreeing to pay above-market rates. Insisting upon compliance with the section 272(b)(2) requirement that the 272 affiliate account for similar transactions with third parties using the same GAAP accounting standards

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<sup>42</sup> *Accounting Safeguards Order* ¶ 170.

allows regulators to compare the transactions on an apples-to-apples basis and detect unlawful cross-subsidization.

The Commission has also recognized the usefulness of “benchmarking” 272 affiliates against each other.<sup>43</sup> To the extent that a 272 affiliate was earning grossly excessive profits or operating at a substantial loss relative to other RBOC long distance affiliates, that would be probative as to whether the RBOC was successfully discriminating in favor of its affiliate or was price squeezing long distance competitors. Again, simply looking at the BOC-affiliate transactions, as Qwest now argues, is no substitute.

Nor is Qwest correct that the Commission can find compliance with section 272(b)(2) so long as Qwest fixes its accounting problems “going-forward.”<sup>44</sup> There is no such thing as being GAAP-compliant “subject to restatement.”<sup>45</sup> Accounting principles are clear that when errors in previous periods are discovered, *current* records must be changed to reflect the impact of such errors.<sup>46</sup> And it is precisely because QCC will need to restate its current books to correct prior errors that Qwest’s CFO acknowledged that Qwest “*is currently unable to certify that QCC’s . . . financial statements are accounted for consistently with GAAP.*”<sup>47</sup>

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<sup>43</sup> *Id.* (requiring all BOC separate affiliates to adhere to GAAP will “impose some degree of uniformity upon these affiliates”).

<sup>44</sup> August 26 Davis Letter at 3 (arguing that “subject to restatement of financial reports for prior periods to reflect appropriate beginning balances, QCC maintains its books, records, and accounts in the manner prescribed by the Commission”); August 26 Shaffer Letter at 2 (“This inability to certify current financial statements does not indicate any issue with the manner in which QCC . . . [is] conducting [its] business today or accounting for transactions on a going-forward business.”).

<sup>45</sup> *Id.* at 1.

<sup>46</sup> *See, e.g.*, Accounting Principles Board Opinion No. 9, ¶¶ 18-19 (Dec. 1966); Accounting Board Principles No. 20, ¶¶ 13, 36, 38 (July 1971).

<sup>47</sup> August 20 Shaffer Letter at 2 (emphasis added); *see also* August 26 Shaffer Ex Parte at 2 (“I am unable to certify the current financial statements, because they build on the past financial  
(continued . . .)

More specifically, when Qwest finishes its audit and restates its books, that restatement will, quite clearly, require Qwest to correct incorrect entries in its books and to make new entries in its current books. For example, it is now known that QCC improperly treated the sale of optical capacity as asset sales and, therefore, recognized the revenue from that sale up-front.<sup>48</sup> Once all of these transactions are identified and properly accounted for as leases, Qwest will need to spread the revenue over the term of the lease.<sup>49</sup> That means Qwest will need to adjust its books to take away revenue it improperly recognized in the past and add entries to account for the proper recognition of the revenue in the current period. These changes will also change both QCC's historical and *current* income statements and balance sheets – assuming QCC actually maintains these separate records. Qwest will need to change QCC's *current* income statement to reflect the erroneous recognition of revenue up-front and Qwest will need to change QCC's balance sheet because the balance sheet is the record of all historical activity from business inception (*i.e.*, the balance sheet reflects all capitalization and corporate profitability of the entity).<sup>50</sup>

Mr. Shaffer's assertions to this Commission that Qwest has fixed all of its problems "going-forward" also cannot be reconciled with the statements he has made under oath to the SEC. In responding to the SEC's request that he certify the accuracy of Qwest's books, Mr. Shaffer opined that no such certification could be given at this time. In so stating, Mr. Shaffer

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(. . . continued)

statements which I have indicated that QCII will be restating.”).

<sup>48</sup> See, *e.g.*, July 29 Qwest 8-K.

<sup>49</sup> See Financial Accounting Standard No. 13 (Nov. 1976).

<sup>50</sup> See also Kathleen Day, *SEC Targets “Swap” Deals by Telecom Firms: Agency’s New Policy on Accounting of Access to Networks May Require Some Companies to Restate Results* (August 20, 2002) (explaining how Qwest will need to restate results to account for swaps of fiber (continued . . . )

stressed that KPMG had just begun its investigation into the accounting practices used by Qwest's former management and that analysis was not yet "complete."<sup>51</sup> Mr. Shaffer also cautioned that while the company and regulators had been focusing on Qwest's treatment of its IRU transactions, "new issues may be raised by the company's internal auditors, or KPMG."<sup>52</sup>

Indeed, Mr. Shaffer and Qwest's new CEO, Mr. Notebaert, have testified that Qwest has not even decided how it intends to handle one of the most fundamental accounting issues – the sales of IRUs for optical transmission capacity sold by QCC. "The company, in consultation with KPMG, currently is analyzing the application of the company's accounting policies to all of the company's optical capacity asset sales transactions, and the appropriateness of the accounting policies themselves. In addition, I understand that the company's policies for IRUs generally are under review by the Commission and may be determined to be inappropriate."<sup>53</sup> Given that Qwest has not yet even resolved what the appropriate accounting treatment should be for these IRUs, there can be no basis for finding that Qwest is now properly accounting for them.

It is no answer to say that the "books, records, and accounts" referenced in section 272(b)(2) are not the same as the "financial statements" referenced in Qwest's SEC filings. The courts have expressly rejected such a tortured reading of "books, accounts, and records." In *US v. Crop Growers Corp.*, 954 F. Supp. 335, 355-57 (D.D.C. 1997), the government charged the

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(. . . continued)

capacity with other carriers that it treated as two independent transactions).

<sup>51</sup> August 16 Qwest 8-K at 10; *see also* Qwest Communications International Inc. 8-K (August 19, 2002) ("[W]e cannot state with certainty when a restatement will be completed.").

<sup>52</sup> August 16 Qwest 8-K at 11; *see also* August 8 Qwest 8-K, Exh. No. 99.1 at 1 ("The company is consulting with its new external auditors, KPMG LLP, on the scope of a restatement and what adjustments would be required. Until such time as these efforts have been concluded, the company cannot indicate the extent to which the results for 2000-2002 will be impacted.").

<sup>53</sup> August 16 Qwest 8-K at 6, 11.

defendants with violating 15 U.S.C. § 78m(b)(2)(A) for failing to keep “accurate books, records, and accounts.”<sup>54</sup> The defendants moved to dismiss the indictment on the ground that the false records at issue were all “financial statements” and that “as a matter of law,” “financial statements cannot be books and records.”<sup>55</sup> The court squarely rejected this contention, finding that it was “common sense” that “financial statements and records are *not* sufficiently distinct to warrant differential treatment.”<sup>56</sup> In this regard, the court also relied on established accounting standards that “undercut[]” the claim that there is a “clear separation” between “financial statements” and “books, records, and accounts.”<sup>57</sup>

In any event, a company’s financial statements unquestionably reflect, and are based entirely upon, its “books, records, and accounts.”<sup>58</sup> The reason why Qwest cannot certify its financial statements to the SEC is because those statements are based on entries made in its “books, records, and accounts” that were not made in accordance for GAAP. In other words, even if Qwest had no obligation to “add up” the revenues and expenses it has recorded, it still indisputably remains the case that the numbers that it has recorded in those accounts are incorrect because they reflect Qwest’s improper treatment for sales of IRUs, equipment and telecommunications services by QCC. Given Qwest’s concessions that QCC has accounted for many transactions improperly, there can be no serious argument that QCC maintains books,

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<sup>54</sup> *Id.* at 355.

<sup>55</sup> *Id.* at 356.

<sup>56</sup> *Id.* at 357 (emphasis added).

<sup>57</sup> *Id.* at 356 (citing Institute of Certified Public Accountant’s *Statement on Accounting Standards* No. 62, Professional Std. at 5 (April 1994)).

<sup>58</sup> See, e.g., *United States v. Arthur Young & Co.*, 465 U.S. 805, 810-11 & n.7 (1984); *Checkosky v. SEC*, 23 F.3d 452, 471-72 (D.C. Cir. 1994); see also *Conley v. United Steelworkers of America*, 549 F.2d 1122, 1123 (C.A. Ind. 1977) (access to “books, records, and accounts” is necessary to “verify” financial statements).

records and accounts – the repositories of those GAAP-violative accounting entries – that are GAAP compliant. And so long as these errors remain uncorrected, the Commission, state regulators and other interested parties have no ability to utilize the separate affiliate’s books to gain an accurate assessment of QCC’s *current* finances or to compare QCC’s finances to those of other BOC 272 affiliates.

Taking Qwest’s argument to its illogical extreme, there would *never* be a basis for denying a section 271 application for the failure of a BOC to maintain GAAP compliant “books, records, and accounts” for its separate affiliate. If the BOC were able to cover up its abuses (as Qwest did for years), then, obviously, no issue would be raised. And if its abuses were brought to light (as Qwest’s now have been), there would be no grounds for denial because, under Qwest’s view, section 272(b)(2) is only concerned with whether a BOC is currently entering “books, records, and accounts” properly and, therefore, approval must be granted so long as the BOC commits to fixing things “going-forward.”

Thus, at the end of the day, all Qwest can offer is to promise the Commission that, at some indefinite point in the future, it intends to establish separate, GAAP-compliant books for QCC. But the Act clearly forecloses granting Qwest’s applications until it can demonstrate that it will be in compliance with section 272 on the day it obtains interLATA authority (and that it will remain in compliance in the future). Absent that showing – and Qwest does not even attempt it here, because it still does not know the full extent of its widespread accounting problems or what must be done to correct them and prevent recurrences – there can be no Commission finding that “the requested authorization will be carried out in accordance with the requirements of section 272.” Qwest will be unable at the expiration of the 90-day period to provide interLATA service in accordance with the requirements of section 272, because it will

not, at that time, even completed its own assessment of how its existing accounting policies must be changed to comply with GAAP.

Given the record, any assurance by Qwest that it will meet the requirements of section 272(b)(2) upon the grant of interLATA authorization can be considered only an “insufficient” paper promise – and a demonstrably untrue one at that.<sup>59</sup> In this regard, it is worth noting that, at least at the time of the application, *Qwest had not even established separate books for its long distance affiliate*.<sup>60</sup> Rather, the separate affiliate apparently has only separate “Charts of Accounts.”<sup>61</sup> Qwest promises that it will establish separate financial statements in the future, but provides nothing but its bare assertion to support this, and there is no possibility that such financial statements could be completed and demonstrably GAAP compliant by next week.<sup>62</sup>

Certainly, no promise of future compliance can be taken seriously until Qwest documents what internal controls it intends to put into place to ensure that QCC’s books remain GAAP-compliant after the internal investigation concludes and the existing irregularities are corrected. In light of the breathtaking scope of Qwest’s violations, existing controls are clearly inadequate, as Mr. Shaffer has candidly acknowledged to the SEC: “the company needs to enhance certain

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<sup>59</sup> *Ameritech Michigan Order* ¶ 347.

<sup>60</sup> *See Brunsting Dec.* ¶ 29.

<sup>61</sup> *Id.* Mr. Davis’ letter also confirms this to be the case. For example, Mr. Davis notes that “it cannot presently certify the financial statements of QCII or QC.” August 26 Davis Letter at 3. Why are QCC’s purportedly “separate” financial statements not mentioned? Because “the financials of QCC are reported in the financial statement of QCII.” *Id.* at 3 n.8. Mr. Shaffer likewise acknowledges that no auditable, separate financial statements exist for QCC when he observes that Qwest is currently investigating QCII’s and QC’s books, but not QCC’s even though most of the questionable practices discovered to date involve sales by QCC. August 26 Shaffer Letter at 3.

<sup>62</sup> *See Brunsting Dec.* ¶ 29.



internal controls.”<sup>63</sup> But the review of Qwest’s internal controls, like its accounting practices generally, is still underway and no specific recommendations have been developed.<sup>64</sup>

## **II. QWEST’S SEPARATE LONG DISTANCE AFFILIATE DOES NOT SATISFY SECTION 272(c)(2).**

Having declared (wrongly) that its current inability to certify that QCC’s books comply with GAAP is legally irrelevant, Qwest maintains that, for purposes of section 271 applications, it need only show that the transactions between its section 272 affiliate and its BOC are accounted for in accordance with GAAP.<sup>65</sup> Even if Qwest were correct, its applications would still have to be denied.

Qwest has made paper promises that its interaffiliate transactions comply with GAAP,<sup>66</sup> but the truth is that Qwest does not presently know the extent of its accounting problems, and any certification of GAAP compliance therefore is entirely premature. Indeed, it is precisely because paper promises are inherently unreliable that the Commission has found that they are “insufficient” to demonstrate compliance with the requirements of sections 271 and 272.<sup>67</sup> Rather, the Commission has determined, and Qwest admits,<sup>68</sup> that the “past and present behavior of the BOC applicant [is] the best indicator” that the BOC will comply with section 272.<sup>69</sup> And with regard to that evidence, Qwest has not shown that its past or present interaffiliate

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<sup>63</sup> August 16 Qwest 8-K at 12.

<sup>64</sup> *Id.* at 10.

<sup>65</sup> *See, e.g.*, August 26 Davis Letter at 2-3.

<sup>66</sup> *See* August Shaffer Letter at 2 (“QCC and QC *are* accounting for transactions in accordance with GAAP for their *current and future operating activities*”) (emphasis added); August 25 Davis Letter at 4 (Qwest is “committed to following GAAP . . . both now and in the future”).

<sup>67</sup> *Michigan 271 Order* ¶ 347.

<sup>68</sup> Brunsting Dec. ¶ 8.

<sup>69</sup> *Michigan 271 Order* ¶ 347.

transactions comply with GAAP. To the contrary, the record regarding Qwest's interaffiliate transactions – which includes admitted “discrepancies” found by auditors<sup>70</sup> as well as evidence of dark fiber transactions, the types of arrangements Qwest has admitted it did not properly account for – precluding any reasoned finding that Qwest will comply with GAAP accounting for such transactions.

Qwest's claims that “the transactions between QCC and QC have been, and are, accounted for in accordance with GAAP”<sup>71</sup> cannot be squared with the facts. First, Qwest has a well-recognized history of interaffiliate transactions that violate section 272. Indeed, Qwest's own witnesses concede that it has “had difficulty identifying QCC affiliate transactions” due to its merger with US West, and that these problems were so severe that they “impacted recording of accruals and billing,” resulting in a mismatch of \$1.5 million dollars of affiliate transactions that required “over 140 interviews” with employees to unravel.<sup>72</sup>

The validity of Qwest's affiliate transactions has also been called into question by independent auditors. In light of the problems Qwest encountered as a result of its merger, it was recommended in a state proceeding that Qwest retain an auditor to examine certain aspects of Qwest's compliance with section 272.<sup>73</sup> The scope of the audit was quite limited – examining only the five month period from April 2001 to August 2001 and determining Qwest's compliance with only a very limited subset of the section 272 safeguards.<sup>74</sup> Nevertheless, in that

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<sup>70</sup> See August 26 Davis Letter at 2.

<sup>71</sup> August 26 Shaffer Letter at 1.

<sup>72</sup> See Schwartz Dec. ¶¶ 19, 44.

<sup>73</sup> See *id.* ¶ 22.

<sup>74</sup> See *id.*, Exh. MES-272-3 (“KPMG Audit Report”). The audit purported to examine Qwest's compliance with sections “272(b)(2), 272(b)(5), and 272(c)(2).” *KPMG Audit Report* at 1. Despite this claimed scope, there is no mention in the audit report that the auditors took any steps  
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period alone, the auditors determined that Qwest's affiliate transactions violated these subsections of section 272 in twelve separate instances, with an impact estimated by Qwest of over \$2.5 million.<sup>75</sup> Thus, while Qwest contends these audits show that Qwest's "controls" were reasonably designed to prevent and detect non-compliance,<sup>76</sup> the reality is that the audits, despite very limited duration and scope, detected myriad, substantial violations of section 272 in Qwest's affiliate transactions.

Second, in prior public filings with this Commission and with the SEC, Qwest has made sworn statements that refute its current claims that all of its interaffiliate transactions comply with the safeguards of section 272. In these documents, Qwest has stated that its (and its auditors') review of its past accounting practices is "ongoing" and is "not complete[]." For example, on August 16, 2002, Mr. Shaffer swore to the SEC that Qwest's holding company and its advisors "are in the process of performing internal analyses of its accounting policies, practices and procedures," and that these "internal analyses are not complete."<sup>77</sup> Qwest had retained KPMG as its new auditor as of May 2002, and KPMG also was "analyzing the company's financial information" and providing "preliminary views" on Qwest's accounting policies.<sup>78</sup> KPMG "has not completed its analysis," nor has it "completed [its] work" on its

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to verify certain aspects of compliance with those rules. Most notably, the auditors did not examine or find that Qwest's 272 affiliate maintained its books in accordance with GAAP.

<sup>75</sup> *KPMG Audit Report* at 2-3. Although Qwest claims that it took steps to remedy these "discrepancies," it took the auditors several weeks before they could issue a supplemental report that could "verify that each of the discrepancies identified . . . had been corrected." Schwartz Dec. ¶ 26.

<sup>76</sup> August 26 Davis Letter at 2.

<sup>77</sup> August 16 Qwest 8-K at 9-10.

<sup>78</sup> *Id.* at 9-10.

“analy[sis of] Qwest’s internal controls.”<sup>79</sup> Indeed, Mr. Shaffer certified that “*new issues* may be raised by the company’s internal analyses, or by KPMG.”<sup>80</sup> Because these analyses were ongoing, Qwest did not file its 10-Q for the second quarter, and determined that it could not “until such time as it has *sufficient certainty* of the impact” of the restatements of earnings that Qwest expects to make.<sup>81</sup>

Despite these substantial and incomplete investigations, Qwest nonetheless proclaimed – just six days after Mr. Shaffer’s letter to the Commission and only ten days after his SEC certification – that *all* of the QC and QCC transactions “have been, and are” accounted for consistent with GAAP.<sup>82</sup> But nothing in Qwest’s recent statements to the Commission explain how, in just a few days (and just weeks after Mr. Shaffer joined the company), it could so confidently reach that conclusion, particularly in light of its admissions that its internal investigations were not complete, and could uncover any number of new issues of accounting improprieties. In those filings, Qwest states that it will be months before its internal analyses are completed. Indeed, as described above, Qwest’s prior section 272 violations required significant effort to remedy, including hundreds of interviews as well as supplemental audit reports (even for violations that appear more limited in scope than those Qwest is now investigating). Given

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 11 (emphasis added).

<sup>81</sup> *Id.* (emphasis added). Mr. Shaffer’s letter to the Commission on August 20, 2002 was similar: he stated that Qwest is conducting an “ongoing analysis of [its] accounting policies and practices” in “consultation with its new auditors, KPMG,” and also “has underway a review of its internal controls.” Mr. Shaffer claimed that Qwest’s “analysis *to date*” has uncovered no GAAP violations for its BOC-272 Affiliate transactions, but conceded that the analysis was “ongoing.” August 20 Shaffer Letter at 1-2.

<sup>82</sup> August 26 Shaffer Letter at 1; August 26 Davis Letter at 2.

Qwest's statements that there is not "sufficient certainty" regarding its accounting practices to enable it to file required reports with the SEC, this Commission has no basis to conclude that there is any certainty that Qwest has in fact accounted for its interaffiliate transactions in accordance with GAAP.

Third, Qwest's claims that its interaffiliate transactions "have been, and are" accounted for consistent with GAAP ignores that its interaffiliate transactions include deals for dark fiber, or optical capacity. As Qwest has admitted, it has already determined that it has improperly recognized revenue from such optical capacity "sales."<sup>83</sup> After analyzing just 18 percent of the holding company's optical capacity transactions from 1999 through 2001, Qwest found that \$1.16 billion in revenue was recognized incorrectly.<sup>84</sup> And Qwest has admitted that it is possible that "certain [accounting] policies as applied to all optical capacity asset sales" may be inappropriate, which would lead it to restate its financial statements for "*all* optical asset sales."<sup>85</sup> Significantly, Qwest's web site discloses that QCC sold fiber optic capacity to QC.<sup>86</sup> The summaries of these transactions reveal very little about the specifics of these transactions, and do not disclose how these transactions were booked by QCC or by QC.<sup>87</sup> However, given the

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<sup>83</sup> August 16 Qwest 8-K at 11; August 26 Davis Letter at 2 n.1.

<sup>84</sup> August 16 Qwest 8-K at 11.

<sup>85</sup> *Id.*

<sup>86</sup> See [http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd4-06\\_12\\_02.pdf](http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd4-06_12_02.pdf); [http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd3-03\\_26\\_02.pdf](http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd3-03_26_02.pdf); [http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd2-10\\_22\\_01.pdf](http://www.qwest.com/about/policy/docs/qcc/documents/TO-lfol-Amd2-10_22_01.pdf)

<sup>87</sup> In this regard, the Commission's rules require that the summary of an interaffiliate transaction "should be sufficiently detailed to allow us to evaluate compliance with our accounting rules" (*Accounting Safeguards Order* ¶ 122) – a requirement that Qwest's bare bones disclosure surely violates.

problems with Qwest's treatment of fiber capacity transactions, there is no basis for the Commission to conclude that these transactions comply with GAAP.

### **III. THE COMMISSION SHOULD OPEN AN INVESTIGATION INTO QWEST'S CANDOR IN THIS PROCEEDING.**

Finally, Qwest's GAAP-related submissions raise serious questions about Qwest's candor in this proceeding, and the Commission should direct the Enforcement Bureau to initiate an investigation. There can be no serious dispute that Qwest's declaration assertions that QCC's "books, records, and accounts are maintained in accordance with GAAP" and that Qwest Communications International Inc. ("QCII"), the parent company into which QCC's books, records and accounts are consolidated, "reports its financial activities in accordance with GAAP",<sup>88</sup> are false statements. Qwest knew that by at least July 28 when it publicly acknowledged that QCII's revenues were inflated by more than a billion dollars by improper accounting for optical capacity sales. Indeed, only two days later, Qwest modified its Chief Operating Officer's Senate testimony to remove the assertions of GAAP compliance that appeared in his earlier House testimony.<sup>89</sup> Qwest also knew that the accounting wrongdoer was QCC, although it did not disclose that fact.

Yet, Qwest did not bring this matter to the Commission's attention for nearly a *month*. Only then did Qwest disclose that its 272 affiliate was the Qwest entity that had violated GAAP. And although Qwest's CFO then conceded that Qwest "is currently unable to certify that QCC's . . . financial statements are accounted for consistently with GAAP," and that the investigations

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<sup>88</sup> Brunsting Dec. ¶ 29.

<sup>89</sup> See August 26, 2002 Letter from Gary Lytle, Vice President-Federal Policy & Law, Qwest to The Honorable Michael G. Oxley (attempting to explain differences between Mr. Mohebbi's March 21, 2002 testimony before the House Committee on Financial Services, Subcommittee on Oversight and Investigations and his July 30, 2002 testimony before the Senate Committee on  
(continued . . .)

and analyses of what “additional controls” are necessary to “ensure QCC’s . . . compliance with GAAP” remain ongoing,<sup>90</sup> Qwest, to this day, insists that the directly contrary declaration assertions are true, and when presented with an opportunity to revise the declarations to delete the false statements, refused to do so.<sup>91</sup>

But at the same time, in filings made under oath, Qwest is telling the SEC (and Congress) an entirely different story. As noted, Qwest has informed the SEC that it is “unable to express a view concerning the accuracy and completeness” of Qwest’s financial statements in light of ongoing outside investigations of Qwest’s widely-reported accounting improprieties.<sup>92</sup> Indeed, the company told the SEC that it cannot even say when Qwest will be able to fully identify and correct its accounting irregularities.<sup>93</sup>

The Commission “expect[s] absolute candor from our licensees, particularly when the precise material fact about which a candor issue is raised is one upon which the Commission may rely and base its ultimate decision.”<sup>94</sup> And, as experience shows, the Commission must demand an especially high level of candor in the section 271 context, both because virtually all of the relevant information is in the BOC’s control and because the strict deadlines in these proceedings make it very difficult to expose false statements by the BOC applicant.<sup>95</sup> The record suggests that Qwest has not met its absolute obligation for truthfulness and has instead attempted

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( . . . continued)

Commerce, Science and Transportation) (attached hereto as Exhibit 4).

<sup>90</sup> August 20 Shaffer Letter at 1-2.

<sup>91</sup> See August 27 Rohrbach Letter.

<sup>92</sup> August 16 Qwest 8-K at 10.

<sup>93</sup> August 8 Qwest 8-K at 1.

<sup>94</sup> *Bell Atlantic-NYNEX Merge Order* ¶ 243.

<sup>95</sup> See generally *SBC 271 NAL Order*.

to deceive the Commission and commenters. Accordingly, the Commission should deny Qwest's application and commence an immediate enforcement action.



## CONCLUSION

For the reasons stated above, and in AT&T's prior submissions in these proceedings, Qwest's section 271 applications should be denied.

Respectfully submitted,

David W. Carpenter  
SIDLEY AUSTIN BROWN & WOOD  
Bank One Plaza  
10 South Dearborn Street  
Chicago, Illinois 60603  
(312) 853-7000

/s/ Mark C. Rosenblum  
Mark C. Rosenblum  
Lawrence J. Lafaro  
Richard A. Rocchini  
AT&T CORP.  
295 North Maple Avenue  
Basking Ridge, NJ 07920  
(908) 221-4263

David L. Lawson  
Mark Schneider  
C. Frederick Beckner III  
Michael J. Hunseder  
SIDLEY AUSTIN BROWN & WOOD, L.L.P.  
1501 K St., N.W.  
Washington, D.C. 20005  
(202) 736-8000

*Attorneys for AT&T Corp.*

September 4, 2002

## CERTIFICATE OF SERVICE

I hereby certify that on this 04<sup>th</sup> day of September, 2002, I caused true and correct copies of the foregoing Comments of AT&T Corp. to be served, by the noted methods, on the following:

Marlene H. Dortch  
Secretary  
Federal Communications Commission  
445 Twelfth Street, S.W.  
Room CY-B402  
Washington, DC 20554  
**By Electronic Filing**

Janyce Myles  
Wireline Competition Bureau  
Federal Communications Commission  
445 Twelfth Street, S.W.  
Room 5C-327  
Washington, DC 20554  
**By Hand**

Qualex Corporation  
Federal Communications Commission  
445 Twelfth Street, S.W.  
Room CY-B402  
Washington, DC 20554  
**By Hand**

/s/Patricia A. Bunyasi  
Patricia A. Bunyasi